



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

DEPOSITORY INSTITUTIONS - THE CHALLENGE OF TODAY'S  
PROBLEMS AND TOMORROW'S OPPORTUNITIES

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FEDERAL DEPOSIT INSURANCE  
CORPORATION

An address by

William M. Isaac, Chairman  
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Washington, D.C.

presented to the

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Bankers Association of America

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A few weeks ago, after accepting the invitation to speak here today, I was visiting in my office with Ken Guenther. I asked him what he thought you would like me to talk about. He reeled off a lengthy answer and when he finished a member of my staff who was present asked, "How many hours are you giving Bill on the program?" Well, we probably could talk for hours about current developments in financial markets, but I assure you I realize my time on the program is limited.

We are in a historic period in the evolution of our nation's financial system. I am convinced we will witness more changes in the next five years than we experienced during the previous 50 years.

Contrary to the claims of some, the government is not the driving force behind this revolution. Indeed, the government is lagging woefully behind developments in the marketplace. Events are now occurring at such breakneck speed that by the time a trend is generally recognized and a consensus is achieved on how to respond, new events render the proposed response ineffective.

Nowhere has this phenomenon been more evident than in our treatment of the thrift industry and its problems. The marketplace has served periodic notice in various ways over the past 15 years that our system of mandatory specialization, accompanied by rigid interest rate controls, is no longer viable.

After much agonizing, we finally responded with the 1980 Monetary Control Act involving a six-year phaseout of deposit interest ceilings and a modest liberalization of thrift asset powers. Although considered revolutionary at the time, how inadequate that law now seems. Continued high and volatile interest rates and competitive pressures from unregulated intermediaries -- aided by the latest in modern technology -- have combined to bring virtually an entire industry to its knees. Anyone who believes a similar fate cannot befall the banking industry is not paying attention to what is happening in the marketplace.

The hour is late. We must get on with a comprehensive package to restructure and aid the thrift industry. I ask your support in that endeavor because I believe it is in the national interest and in your best interest. I do not believe the banking industry has anything to gain from continued erosion of public confidence in thrifts. Moreover, until we stabilize conditions in the thrift industry it will not be possible to implement the measures you need to compete effectively in the new environment.

I recognize there is no good cure to the thrift problems other than a prompt, substantial decline in interest rates. There are, however, a number of measures we can take to minimize the disruptions to our financial system and to insure the problems do not recur every few years.

The first is swift enactment of the Regulators' Bill to give the insuring agencies -- particularly the FDIC -- greater flexibility in dealing with failing institutions. We appreciate the past support IBAA has given this Bill, but we cannot accept the House-passed version which unnecessarily ties our hands.

As you know, we were confronted recently with the prospective failure of a \$1 billion savings bank in Minneapolis. Your organization and CSBS rallied behind us to push through the Minnesota legislature -- by unanimous vote in four days -- a bill permitting that bank to be converted to a commercial bank and authorizing its acquisition by an out-of-state bank holding company. That episode shines brightly. It demonstrates we can resolve the thrift problems if we work together. It also establishes conclusively the value of an active, interstate bidding process when we are dealing with a large failure. We saved over \$50 million as a result of the legislation. I need not remind you that a good portion of that money would have come directly from your pockets. Finally, it shows that the insuring agencies will use the new authority responsibly and will not consummate an interstate acquisition unless we have a compelling reason to do so.

The second measure that we need is swift passage of the Garn Bill or something similar to it. The Garn Bill would give thrifts greater asset powers and override state usury laws and due-on-sale prohibitions. The Bill is important in the long run because it will enable thrifts to diversify and become more viable financial intermediaries. The legislation is also extremely important in the short run to facilitate our handling of failing thrifts. If you have ever tried to market a distressed thrift in a state with a restrictive usury law and a prohibition against enforcement of due-on-sale clauses, you will appreciate the urgent need for this Bill.

Third, we need to consider accounting reforms to give thrifts greater ability to restructure their asset portfolios and, at the same time, to help insure they do not pursue the same policies in the future that created the present problems. We have not endorsed the loss-deferral rule authorized by the Federal Home Loan Bank Board because it does nothing to prevent a recurrence of the present problems, and we think it is unlikely to be beneficial unless interest rates remain

at present levels or higher for an extended period -- in which case the rule will become academic. However, we are exploring other possible accounting reforms and, if appropriate, we will adopt them.

Fourth and finally, the DIDC must authorize comparatively swift deregulation of deposit interest rate ceilings. We have watched banks and thrifts lose deposits and customers to money market mutual funds for most of the past four years. Not only is this causing permanent, long-term damage in terms of customer defection, those lost deposits are being replaced by more expensive borrowed funds, exacerbating the current earnings problems. The 3½-year phaseout schedule, which seemed so controversial six months ago, now appears woefully inadequate.

You have probably noticed that I did not include in the package a mortgage warehousing plan or capital support program, both of which appear to be gaining favor in some circles. Assuming we can afford this type of subsidy -- a dubious proposition in view of the Federal deficits confronting us -- it would nevertheless be unfortunate if it were enacted without being accompanied by the kinds of structural reforms I have outlined.

It is hard to imagine a subsidy generous enough to eliminate the need for additional mergers of thrifts. Thus, the Regulators' Bill and the Garn Bill will still be necessary to facilitate takeovers. Moreover, it seems clear that thrifts will not be viable competitors in a deregulated interest rate environment without greater asset flexibility. A subsidy, in the absence of reforms in the financial structure that led to the current problems, may buy some time but it will not prevent repetition of the problems.

I know many of you are concerned about how we will generate funds for housing if we abandon our system of mandatory specialization. I have no doubt that if a demand for housing finance exists, financial intermediaries will supply the necessary funds at market rates. If we get our nation's financial house in order, the market price will be affordable. If, beyond that, we desire a special housing subsidy, it ought to be provided out of general revenues directly to lenders to entice them to make housing loans at below market rates or directly to borrowers to help them better afford the going rate. If we have learned anything from the current plight of the thrift industry, it is that private financial institutions cannot afford to subsidize housing finance and savers are not willing to do so.

It would be natural for you to ask at this point: "Why should we support this restructuring of the thrift industry, what's in it for the community bank?" After all, community banks have spent the past 20 years locked in vigorous competition with these institutions. Thrifts have had branching, interest rate, regulatory and tax advantages. Now that the "chickens have come home to roost," people want to give the thrifts greater asset powers.

Believe me, I have been associated with banking for long enough to know exactly how you feel. However, I have two responses. First, it is clearly in the national interest and in the interest of all members of our financial community that we resolve the thrift problems with a minimum of disruption and delay. Bankers, perhaps more than any other group in our society, have always been willing to lend a hand in times of national need. This is such a time.

Second, I am firmly convinced that the thrift industry is your competition of yesterday, not tomorrow. I am just as firmly convinced that you are not properly positioned to meet the competition of tomorrow and will not be unless and until some structural reforms are made.

The competition of tomorrow will come from nondepository institutions such as Sears, American Express, Merrill Lynch and Prudential. The Chairman of Sears recently unveiled ambitious plans for that organization to move into full scale lending and deposit taking throughout the nation. Laying down the gauntlet to the banking industry, he asserted that opponents would have no easier time preventing these activities than they would in forcing the closure of the neighborhood Sears' stores.

I am convinced of the strength and true value of our nation's community banks. You play a critical role in the life of your communities. Given the freedom to compete on an equal basis, you can withstand any competitive challenge.

The only concern I have for your future stems from my fear that we will not move swiftly enough to free you from the oppressive burden of excessive regulation. No one tells Sears what rate it may pay depositors -- nor where it may open a convenient new office. No one forces Sears to comply with the Community Reinvestment Act, the Home Mortgage Disclosure Act and myriad other laws, regulations and paperwork requirements applicable to banks.

Nor is it likely that anyone ever will dictate to Sears on these subjects. The only alternative from a practical political and economic standpoint is to unshackle your hands. We at the FDIC are attempting to do just that within the limits of our statutory authority.

First, we believe that the basic ground rules must be made as fair as possible. This led us to publish a policy statement on capital adequacy which expressly rejects the notion that smaller banks must maintain higher levels of capital simply because they are smaller. The level of required capital is an important element in dictating the pricing of bank services, the rate of growth and the ability to make acquisitions. In recognition of this, our policy statement provides that the minimum acceptable level of capital in a sound, well-diversified state nonmember bank -- irrespective of its size -- is 5 percent.

The deposit insurance system, as currently structured, is not as fair as it might be. It assesses premiums on the basis of domestic deposits irrespective of the risk in an institution. Moreover, it tends to erode marketplace discipline and protect marginal, high-risk competitors. We are exploring several possible reforms, all of which would require legislation.

The current antitrust laws and policies seem misdirected and unfair to smaller institutions. In my judgment, we focus on comparatively narrow definitions of the relevant product and geographic markets and pay too little attention to the general structural effects of acquisitions. Our policies lead us to permit the acquisition of the largest bank in a community by a major holding company but to deny the merger of two smaller, locally-owned banks in the same town. They also lead to the acquisition of Dean Witter and Coldwell Banker by Sears, the acquisition of Shearson by American Express and of Bache by Prudential while many banks are precluded from acquiring comparatively small firms in their most natural markets.

Finally, we must arrive at a new definition of what constitutes the business of banking and impose uniform requirements on those who participate in the business. How can we permit American Express to acquire Shearson which in turn owns a state nonmember bank while prohibiting member banks from being affiliated with securities firms? How can we justify the acquisition of an insured national bank by Gulf & Western simply because the bank agrees not to generate new commercial loans? Is it fair and appropriate for money market funds to operate without reserve requirements? Should a steel company be permitted to own a savings and loan association, particularly as we expand S&L asset powers? Laws that lead to these kinds of results are in desperate need of rationalization.

Second, we believe the regulatory burdens must be reduced for all banks, particularly the smaller institutions for whom the burdens of compliance have a disproportionate

impact. Smaller institutions have neither the in-house expertise to cope with the voluminous, unwieldy consumer laws nor a sufficient volume of transactions over which to spread the cost of compliance.

We are in the process of eliminating and streamlining our regulations to the extent possible. We have urged and will continue to urge Congress to go further in undertaking a sweeping revision of the laws that underlie our regulations. Moreover, we support small-bank exemptions or simpler versions of laws and regulations for small banks whenever feasible.

We have instituted a series of compliance seminars for bankers throughout the country to promote a better understanding of the laws and regulations. Our examiners have been instructed to be helpful and constructive in banks which are making a good faith effort to comply with the laws. They have been given maximum latitude, consistent with our statutory responsibilities, to use their good judgment and common sense in dealing with problems of noncompliance.

We are implementing a series of reforms with respect to our examination and application procedures in order to operate more efficiently and further reduce the burdens imposed on you. Under our divided examination program, instead of the state authority and the FDIC each examining a bank each year, we alternate. The state examines one year and the FDIC the next, and we share the reports. This program reduces the burden on our banks and saves the states and the FDIC millions of dollars annually.

Our application forms have been substantially reduced in size and complexity. We are utilizing common application forms in most states so that you fill out a form for the state and simply send us a copy. Applications are processed simultaneously by the state and the FDIC to minimize delays.

Many applications currently are approved by our regional offices under delegated authority. We will soon adopt additional delegation rules to further expedite our processing. Moreover, we are considering outright elimination of the requirements for applications in some situations -- in particular, branching proposals by banks that meet certain criteria.

I could go on, but I believe I have given enough examples to show the direction in which we are headed. You are operating under an excessive regulatory burden, and we intend to do everything we can to alleviate it.

Third, and finally, we must give you the tools you need to compete in the new environment. Most importantly, we must move swiftly to deregulate deposit interest rate ceilings. Beyond that, you should be given broader authority to move into new product and geographic markets.

I have covered considerable territory in outlining the steps that should be taken to resolve the problems of the thrift industry and to permit commercial banks to remain vigorous competitors in the world of tomorrow. It will not be possible to take all these steps in unison. Congress does not function that way.

What is needed is for banks of all sizes to come together and agree on an agenda and their priorities within that agenda. Then the program should be implemented as swiftly as possible in however many steps may be desired or required.

Without question, the most urgent need is to address the thrift problems. Unless and until that is done, little else can or should occur.

There will always be an important place in our financial system for the personalized, efficient service offered by a well-run community bank. Large banks and other financial intermediaries play an important role in our economy and provide services that cannot be matched by smaller organizations. But their role is no more important than the role you play in your communities, and you have many advantages in your competition with them.

I have a great deal of faith in you. I have faith that you will support what is right for the nation. I also have faith that if we implement reforms to promote a basic fairness in the ground rules, to get the burden of excessive regulation off your backs, and to provide the requisite competitive tools, you will not only survive but prosper in the years ahead.

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